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No. 71-979

In the Supreme Court of the United States

OCTOBER TERM, 1971

CITY OF CHICAGO, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A, pp. 1a–54a) is not yet reported. The Federal Power Commission's opinion (Pet. App. B) is reported at 42 F.P.C. 738, and its opinion denying rehearing (Pet. App. C) is reported at 42 F.P.C. 1089. The decision of the Hearing Examiner is reported at 42 F.P.C. 755.

JURISDICTION

The judgment of the court of appeals (Pet. App. A, p. 55a) was entered on December 2, 1971, and the petition for a writ of certiorari was filed on January 31,

1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the Federal Power Commission acted within its authority under the Natural Gas Act in promulgating a rule that on-system natural gas produced by natural gas pipeline companies and their affiliates from leases acquired after the date of the rule shall be valued for rate-making purposes at a cost-based area rate instead of on an individual cost-of-service basis.

2. Whether the Commission improperly relied on evidence not contained in the record in concluding that a natural gas shortage is impending.

3. Whether the Commission erred in specifying that the new-lease area rate for pipeline producers will be the same as that for independent producers, without using a different rate of return or adjusting it for possible income tax benefit spill-overs.

STATUTES INVOLVED

The pertinent statutory provisions are set forth in Pet. App. D.

STATEMENT

This case involves a Commission determination that natural gas produced by natural gas pipeline companies or their affiliates from leases acquired after October 7, 1969, and transported through their own respective pipelines (so-called "on-system" gas) should be valued for rate-making purposes at the cost-based area rate applicable to independent pro-

ducers. The court of appeals affirmed in a comprehensive opinion (Pet. App. A, pp. 1a–54a).

This proceeding began as a part of the *Hugoton-Anadarko Area Rate Proceeding* when the Commission included as an issue whether on-system gas produced by a pipeline company or its affiliate should be valued on an area rate basis for rate-making purposes. After it became apparent that the Hugoton-Anadarko area was not a typical area for pipeline production throughout the United States, the pipeline production rate question was severed from the proceeding and a new inquiry was instituted. The new proceeding was divided into phases, only the first of which (Phase I) is involved here. The Commission limited the issue in Phase I to "What is the most appropriate pricing method to be applied to natural gas utilized in a pipeline's interstate system which is produced by the pipeline or its affiliated producing company from leases acquired after the date of determination of this issue." (Pet. App. A, pp. 8a–9a; Pet. App. B, pp. 56a–57a.)

After extensive hearings, the Examiner concluded that the traditional cost-of-service approach should be retained, with certain modifications aimed at providing a transition from cost-of-service regulation to area rate regulation (Pet. App. A, pp. 9a–11a; Pet. App. B, p. 58a). The Commission, however, decided that the transition should be made now, in order to eliminate anomalies which result from the utilization of cost-of-service pricing, and because pipeline-owned reserves, like reserves owned by independent producers,

have been declining at a time when there are substantial indications of an impending gas shortage and thus a stimulus for development of new reserves of the former type is needed. The Commission concluded that the area rate method would provide the desired stimulus and protect consumers from bearing the full cost of unsuccessful exploration, and also would establish desirable uniformity in regulating new production. It therefore promulgated a rule providing that "[a]s a matter of policy" on-system gas produced by pipelines and their affiliates from leases acquired after the date of the rule (October 7, 1969) will be valued for rate-making purposes at the same area rate applicable to independent producers in the area within which the lease is located. (Pet. App. B, pp. 59a–61a, 72a–73a.)[1]

The petition for review in the court below was supported by "four main arguments: (1) The Commission improperly relied on evidence not contained in the record in reaching its decision; (2) the Commission, in light of the record before it, improperly abandoned cost-of-service valuation of gas produced by pipeline companies; (3) assuming area rates were appropriate for regulation of pipelines, the Commission erred in allowing such companies the same rate of return it allowed independent producers; and (4) the Commission did not give proper recognition to certain facets of the law applicable to income tax benefits"

[1] The Commission specified that where an area rate has not been established, it will use "the appropriate in-line, or guideline, price applicable to independent producers" for the area involved (Pet. App. B, p. 67a; see also *id.* at p. 72a).

(Pet. App. A, p. 12a). Although it recognized that the present proceeding "fits into the category of rule-making" rather than adjudication, the court stated that "searching and careful" consideration of the Commission's rule was called for "to determine whether a reasoned conclusion from the record as a whole could support the premise on which the Commission's action rests" (*id.* at pp. 14a, 25a).

The claim that the Commission erred in relying on extra-record statistical data concerning a shortage in natural gas was rejected on the ground that such reliance "did not in any way unfairly deprive petitioner of any substantial right," since there was evidence of the record from which the Commission's conclusion could properly be drawn, the subject had been raised in numerous earlier proceedings and was clearly present in this case, and "the sole issue here involves the proper *method* to be followed" in valuing newly-produced gas, not the actual value thereof, and a finding of the precise magnitude of the possible gas shortage was not essential to the determination of this question (Pet. App. A, pp. 28a–32a). Nor, the court held, was there substance to the contention that on the facts of this case the Commission improperly departed from individual cost-of-service regulation under the teaching of *City of Detroit* v. *Federal Power Commission*, 230 F.2d 810 (C.A. D.C.), certiorari denied, 352 U.S. 829. The court explained that "[t]he main concern" of its decision in that case "was that wholesale abandonment of a cost-oriented approach to rate regulation would also be the abandonment of the long utilized

point of departure for analysis of the reasonableness of a given rate to the consumer;" that problem is not present here, since "area rates are essentially rates based on composite cost of service for all producers in a given geographic area," and thus the instant case differs from *City of Detroit* in that "abandonment of cost oriented regulation is not here proposed" (Pet. App. A, pp. 37a–39a).

The court also sustained the Commission's refusal at this time to use in the area rate formula for pipeline producers a rate of return component different from that set for independent producers or a separate income tax component for each pipeline company. It concluded that "[t]he record supports" the Commission's finding that the aggregate costs, including the costs of capital, to produce gas from new leases are similar for independent producers and pipeline producers (Pet. App. A, pp. 42a–43a). While holding that it was therefore proper for the Commission to use the same rate of return for both groups as a "starting point", the court admonished that this would not be so "[i]f future costs for the two groups are significantly different;" the Commission "must continually re-evaluate its prediction as experience accumulates," and "the propriety of actually allowing the two groups a single rate of return will have to be determined on the basis of the facts developed in an actual area rate case" (*id.* at pp. 44a–45a). The court further held that the income tax component of the area rate "should not be singled out for special treatment" since it merely represents a "cost" of doing

business, and, "[a]s with all other elements of cost, * * * the average amount expended by a producer in the area is the appropriate amount for inclusion in the [area] rate" (*id.* at pp. 48a–49a). The court again cautioned that actual experience might show that income taxes should be handled differently for pipeline producers than for independent producers, since pipelines have another activity (pipeline transmission) which is under the Commission's jurisdiction and to which tax benefits from production could be "spilled-over;" but the court concluded that that determination also "would be most appropriately undertaken in the context of an actual area rate proceeding" (*id.* at pp. 50a–51a).

ARGUMENT

Petitioners' contentions were presented both to the Commission and to the court below, and were rejected following careful consideration. The Commission's action in this case comports fully with this Court's decision in *Permian Basin Area Rate Cases*, 390 U.S. 747, the holding below sustaining it is therefore correct, and there is no conflict of decisions or other reason for further review.

1. The Commission's determination that on-system natural gas produced in the future by pipeline companies should be valued for rate-making purposes at an area rate rather than at an individual cost-of-service rate is fully consonant with its obligations and powers under the Natural Gas Act. This Court in the *Permian Basin* case sustained the area rate method for independent producers. The Commission found,

and the court below agreed, that the reasons supporting use of the area rate method for independent producers are similarly applicable to rate regulation for pipeline producers. It follows that area rates may properly be utilized for pipeline producers too, as the Commission and the court below concluded.

Contrary to petitioners' contentions (Pet. 9–18), this determination in no way conflicts with the principles announced by the court below in the *City of Detroit* case, *supra*. Although the court there set aside a Commission decision to value gas production on the basis of field prices instead of the costs of service, the court's opinion specifically stated that the Natural Gas Act does not require that the individual cost-of-service method always be used (230 F. 2d at 815). Rather, the court held merely that valuation must in some rational manner be based on cost data in order to satisfy the statutory standard that it be "just and reasonable." In the present case both the Commission and the court of appeals fully recognized the teaching of *City of Detroit*, and properly held that the determination here complied with its principles since the area rate method is based on cost of service (the composite cost of service for all producers in a specific geographic area). See Pet. App. A, pp. 34a–39a;

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[1] The other decisions cited by petitioners at Pet. 9, n. 17 (*Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591; *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581; and *Panhandle Eastern Pipe Line Co.* v. *Federal Power Commission*, 324 U.S. 635) also indicate that the individual company cost-of-service approach is not the only proper method of determining rates. The Court reaffirmed this view in the *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at 775.

Pet. App. B, p. 62a. Nothing in *City of Detroit* suggests that the area rate method—subsequently upheld by this Court in *Permian Basin*—is improper. See *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 310 n. 16.

Petitioners also argue (Pet. 13, 17–18) that there are significant differences between pipeline producers and independent producers. But, so far as is pertinent here, the two groups are comparable; the Commission found on the basis of ample evidence that the costs of both groups in exploring for and developing new gas reserves are similar (Pet. App. B, p. 63a), and consequently that area rates with respect to production from such reserves are appropriate for application to both groups. Moreover, the Commission's determination to adopt a single area rate basis for regulating both pipeline and independent producers serves to avoid the "most serious question" of undue discrimination that would arise if a different method were employed for each competing group (*id.* at p. 61a). Petitioners' contrary contention is premised on differences between the two groups concerning past operations. As the court below concluded (Pet. App. A, pp. 42a–43a), however, these differences do not refute the Commission's findings concerning the issue that is relevant here—what it will cost to produce gas from new leases. As to this, the Commission's finding of cost comparability is supported by the record.

2. The court below properly held that the Commission's reliance on extra-record data concerning a shortage of natural gas was not error. Petitioners conten-

tions on this issue are fully answered in the opinion below (Pet. App. A., pp. 26a–33a), on which we rely. We note also that in the *Permian Basin* case this Court similarly considered post-record reports of the American Gas Association concerning natural gas reserves (390 U.S. at 816, n. 100 and n. 101).[3]

3. The court below also properly rejected petitioners' contentions concerning the rate of return and income tax components for the reasons stated in its opinion (Pet. App. A, pp. 40a–51a). Contrary to the suggestions in the petition (Pet. 16–17, 25), the court was fully aware that the Commission was already conducting proceedings to determine independent producer area rates which would establish the "starting point" for pipeline producers as well. See Pet. App. A, pp. 6a, n. 15; 28a, n. 66; 29a, n. 69; 31a, n. 72.[4]

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[3] There is now no longer any doubt that there is in fact a serious shortage of natural gas. See *Southern Louisiana Area Rate Cases (Austral Oil Co. v. Federal Power Commission)*, 428 F. 2d 407 (C.A. 5), certiorari denied, 400 U.S. 950; *Hunt Oil Co. v. Federal Power Commission*, 424 F. 2d 982 (C.A. 5); *Louisiana Power & Light Co. v. United Gas Pipe Line Co.*, C.A. 5, No. 71-2550, decided January 14, 1972, certiorari granted *sub nom. Federal Power Commission v. Louisiana Power & Light Co.*, March 6, 1972, No. 71-1016.

[4] The Commission has conducted area rate proceedings for the following geographic areas in addition to the Permian Basin: Southern Louisiana (*Southern Louisiana Area Rate Proceeding*, FPC Op. No. 598, decided July 16, 1971, appeal pending, *Southern Louisiana Area Rate Case (Placid Oil Co. v. Federal Power Commission)*, C.A. 5, No. 71-2761); Texas Gulf Coast (*Texas Gulf Coast Area Rate Proceeding*, FPC Op. No. 595, decided May 16, 1971, appeal pending, *Texas Gulf Coast Area Rate Case (Public Service Commission of the State of New York v. Federal Power Commission)*; C.A. D.C., No. 71-1828); Hugoton-Anadarko Area (*Hugoton-Anadarko*

There is no substance to petitioners' claim that the court was mistaken in suggesting that the rate of return and income tax issues could be further considered in future Commission proceedings, and that in fact "[t]here is no tomorrow" for them (Pet. 17). The rule involved here applies only to on-system production from leases acquired after October 7, 1969, which as yet comprises only a very small part of total pipeline production. And rates fixed in the proceedings are subject to modification in the future. It is clear that the issues involved will receive further consideration by the Commission "as experience accumulates" (Pet. App. A, p. 45a); indeed, additional proceedings have been commenced for the Permian Basin area for the express purpose of considering "all issues pertaining to the possible separate treatment of pipeline ing to the possible separate treatment of pipeline producers," including the rate of return issue and the income tax issue (Presiding Examiner's Order dated March 6, 1972, *Permian Basin Area Rate Proceeding*, FPC Docket No. AR70–1). It is significant also that one or more of the petitioners here actually participated in each of the specific area rate proceed-

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Area Rate Proceeding, 44 F.P.C. 761, appeal pending, *Hugoton-Anadarko Area Rate Case* (*State of California* v. *Federal Power Commission*), C.A. 9, No. 71–1036); Other Southwest Area (*Other Southwest Area Rate Proceeding*, FPC Op. No. 607, decided October 29, 1971; appeal pending, *Other Southwest Area Rate Case*, (*Shell Oil Co.* v. *Federal Power Commission*), C.A. 5, No. 72–1114). An area rate for the Rocky Mountain Area is presently before the Commission (*Rocky Mountain Area Rate Proceeding*, FPC Docket No. R–425).

ings conducted so far,[5] and presumably could have raised any issue (including pipeline producer issues) that they deemed important during those proceedings.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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[5] All three petitioners participated in the proceedings for the Hugoton-Anadarko and Texas Gulf Coast areas (see n. 4, *supra*); the City of Chicago and the American Public Gas Association (APGA) participated in the Other Southwest Area proceeding; APGA participated in the proceedings for the Southern Louisiana and Rocky Mountain areas.